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C O N F I D E N T I A L SECTION 01 OF 04 BUENOS AIRES 001270

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CONCERNS OVER DIRECTION OF ARGENTINE ECONOMY

REF: A. BUENOS AIRES 1263
¶B. BUENOS AIRES 1236
¶C. BUENOS AIRES 1224

Classified By: Ambassador E.A. Wayne for Reasons 1.4 (b,d)

Summary

¶1. (C) During a visit that coincided with the Argentine President's surprise announcement that the GoA would pay Paris Club debts (reftels), Federal Reserve Bank Governor Randall Kroszner received a pessimistic message about the future of the Argentine economy from industrialists, economists, bankers, and Fitch Rating Agency. All emphasized the importance of the GoA's decision to pay defaulted Paris Club debt. They stressed, however, deep concerns about inflation, slowing growth, lack of access to international capital markets, the looming impact of global financial uncertainty and decelerating world growth, and the GoA's reluctance to alter its increasingly inappropriate policy mix. While acknowledging some positive developments, including slowing expenditure growth, tightening monetary policy, and still robust fiscal and current account surpluses, the consensus view was that Argentina faces difficult years ahead. Kroszner received more upbeat briefings on the economy from the president of a government-owned bank and from the Argentine Central Bank President (septel). End Summary.

Kroszner Visit Coincides with Paris Club Statement

¶2. (U) Federal Reserve Bank Governor Kroszner visited Argentina September 1-2 at the invitation of Argentine Central Bank (BCRA) President Martin Redrado in order to speak at the BCRA's annual monetary and banking conference. The conference, titled "Financial Turbulence: Impact on Developed and Emerging Economies," featured Central Bankers, economists, and bankers from around the world. Details on the conference, Kroszner's participation in it, and Kroszner's meeting with Redrado are provided septel.

¶3. (C) Kroszner's visit coincided with Argentine President Cristina Fernandez de Kirchner's (CFK) unexpected mid-day September 2 announcement that the GoA would pay off all Paris Club debt (see reftels for readout on that decision and local and international reaction). The news dominated Kroszner's subsequent meetings, as local opinion-makers scrambled to analyze how this would affect their predictions for the

economy and GoA policies. Post reported Ref C the generally downbeat assessments that five prominent Argentine economists gave Kroszner during a September 2 lunch.

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Industry Laments GoA attitude towards Private Sector
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¶4. (SBU) On September 1, the Argentine Entrepreneurs Association (AEA), a grouping of Argentina's most powerful industrialists and service industry providers, hosted Governor Kroszner and Ambassador to lunch. Attendees included Eduardo Elzstain, Chairman of real estate investment group IRSA, Carlos Franck, Finance Director of the Argentine multinational Techint Group with major steel and energy infrastructure assets in the hemisphere, Alberto Grimoldi, President of a leading Argentine footwear manufacturer, Alberto Hojman, president of home appliance manufacturer BGH group, Hector Magnetto, President of the Clarin media group, Carlos Miguens, President of energy and agricultural group MB holdings, Manuel Sacerdote, representative of the Loma Negra cement manufacturing group, co-founder of agriculture sector investor SAPRESA and former President of BankBoston Argentina, and Enrique Pescarmona, President of the IMPSA multinational group with major hydro energy turbine interests.

¶5. (SBU) The initial conversation focused on Kroszner's responsibilities as a Fed governor, with pointed questions on current turmoil in the U.S. financial sector ("How did the US Fed fail so miserably in predicting the size and broader economic impact of the sub-prime crisis?"), the contribution

of the Bush administration's stimulus package to a burgeoning U.S. deficit, and whether the Fed had abdicated on its responsibility to fight inflation by responding to the crisis with 325 basis points of interest rate cuts.

¶6. (C) Grimoldi offered a synthesis of AEA member views on the economy, noting the depths of the 2001/2 financial crisis, subsequent five years of 8-9% real GDP growth rates, the GoA's accomplishment of a sustained primary fiscal surplus ("for the first time in our nation's history!") the impact of the commodity price boom on rural production, and the impact of high inflation (and the GoA's inability or unwillingness to control it). He lamented the GoA's confrontational attitude and interventionist approach towards the private sector writ large, arguing "the GoA does not believe that the private sector will build the country, and so the concept of a 'Schumpeterian entrepreneur' does not exist in Argentina today." (Grimoldi was referring to economist Joseph Schumpeter's capitalist vision in which the creative entry of entrepreneurs is the principal force sustaining long-term economic growth, even as they destroy the value of established companies.)

¶7. (C) Miguens supported Grimoldi's assessment, noting that the Brazilian government stands out in its support for the local business sector. He contrasted this with the GoA, which he said declines even to consult the private sector on how they can work together to build a more productive nation. In response to the Ambassador's question as to whether the GoA would implement needed macroeconomic reforms, the consensus was only as needed to maintain the sufficient flow of revenues to federal coffers to sustain the Kirchner administration's power and patronage base. If forced to act by necessity, they will, but not before, one indicated.

Citibank Retrenches, Expecting the Worst

¶8. (C) During a late evening conversation, Citi-Argentina's President Juan Jose Bruchou gave an even more pessimistic assessment. He calling current economic problems in

Argentina the result of the GoA's political failures, and warned that the situation will worsen rapidly if the GoA does not make major changes. He claimed that Citi and other banks had made good profits in recent years, but that was changing rapidly. He said "sentiment" in Argentina was bad, but it was horrible "outside" (i.e., among Wall Street firms). This was due to annual inflation at 25% ("despite BCRA President Redrado's decent efforts"), GDP growth slowing to 2-4% in 2009, limited control over spending and growing subsidies, and no access to international capital markets, "except Chavez at 15%" (referring to the GoA's recent $1 billion sale of bonds to the GoV at a yield of almost 15%). He noted that this rate was approaching pre-2001 default bond yields. He also pointed to the lack of incentives to invest, energy bottlenecks, lack of transparency, and GoA intervention.

¶9. (C) In preparation for a worsening business environment, Bruchou said he was getting Citi out of the consumer finance business and will be protecting his balance sheet by maintaining a highly liquid position. This will be costly, he admitted, but it is necessary protection. He argued that Citi Argentina's loan portfolio remains healthy, but he expects the overall financial sector's non-performing loan rate to increase in the near term. He contended that most other banks operating here will pursue similar protective measures, and so credit markets will get even tighter. Because banks in Argentina intermediate a very short-term funding base (their deposit maturities average under 30 days), they are unwilling to provide significant long-term lending.

¶10. (C) With the economy operating at near full-capacity, Bruchou stated that capital investment is needed for the economy to continue growing. But this will not happen under the current GoA policy regime. The good news, he commented, is that the macro fundamentals remain strong, so the GoA could turn things around rapidly by pursuing more rational economic policies. He contrasted this with 2001, when the GoA had few options to save the situation. Also good news was that, for the first time since 2003, Nestor Kirchner lost a battle when Congress rejected the GoA's export tax increase on July 18. "Nestor uses tax revenue to control the

provinces, which are all running deficits, but now he's running out of money -- and options." He closed by warning that the combination of slowing growth and high inflation would lead to increasing social tension in 2009.

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Alternative View from State-Owned Banco de la Nacion
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¶11. (SBU) In a September 2 meeting with state-owned Banco de la Nacion (BN) President (and former FpV congresswoman and chair of the Industry Committee) Marco del Pont, Kroszner probed for BN's role in promoting Argentine industrial development. Marco del Pont highlighted BN and other GoA state-owned bank's focus on providing small and medium enterprise (SME) with investment as opposed to working capital credits. She also highlighted state banks' role in addressing the Argentine financial system's critical shortage of long-term financing. Private banks, she said, were continuing to focus on highly profitable short-term consumer finance and short-term SME working capital lines of credit. She supported Internal Commerce Secretary Guillermo Moreno's efforts to encourage private banks to lower their rates.

¶12. (SBU) For its part, BN had recently launched an ARP 700 million (US$ 230 million) SME line of credit for 10-year maturity financing. Marco del Pont also previewed an announcement made later that day by CFK of a joint BN/BNDES (Brazil's development bank) US$ 200 million line of credit to finance development projects in Argentina. A similar joint line of credit, she said, is being negotiated with the Bank of China. Finally, Marco del Pont noted a recent BCRA rule

change which will permit BN to provide bridge financing to pension funds who will issue trust securities to finance additional capital investment.

¶13. (C) In response to Kroszner's question on the distorting impact of high GoA export taxes that reduce net investment in Argentina's highly productive agricultural sector, Marco del Pont denied this was the case. She called the Argentine agricultural sector highly profitable and export tariffs an effective tool for the state to capture extraordinary rents and redistribute them domestically. The Argentine agricultural sector continues to invest at record rates, she said, and the GoA's variable export tariff proposal (which failed in Congress July 18) would have offered these investors an "equilibrating mechanism" that ensured "adequate" profitability.

Argentine Economists Trade Pessimistic Views

¶14. (C) Five of Argentina's most prominent economists echoed many of the criticisms and concerns highlighted above during a September 2 lunch at the Ambassador's residence. FIEL Chief Economist Daniel Artana, ex-Central Bank President Javier Gonzalez-Fraga, high-profile consultant Ricardo Arriazu, Banco Ciudad President Federico Sturzenegger, and UBS economist Javier Kulesz were in agreement on the fundamental strength of the Argentine economy, and especially the agricultural sector, but without exception opposed the GoA policy mix. Interestingly, they also seemed to agree that high inflation is mostly the result of rapid monetary growth, which has averaged over 20% y-o-y until recently.

¶15. (C) Several also raised concerns about Argentina's dependence on commodity exports. Artana noted that commodities comprise 60% of exports, and with relatively high debt/GDP levels, negative real interest rates, procyclical fiscal policy, and tax revenue 10 percentage points of GDP higher than in the 1990s, a 20% or larger fall in commodity prices (from current levels) could have devastating consequences. Arriazu said he had just finished an analysis of the impact of a 20% commodity price decline, and stated it would result in foregone export revenues of $7 billion, a current account deficit, and fiscal problems due to lower tax revenues. Arriazu argued that the world was seeing a 1970s-like commodities bubble, which would soon pop, and also claimed that the current trade balance would be in deficit if measured in 2001 (or even 2007) prices -- meaning most of the trade surplus is a price phenomenon, not the result of higher volumes.

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Fitch Considers Rating Review Following PC Announcement
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¶16. (C) In a closing meeting September 2, Fitch-Argentina's Managing Director Lorna Martin blamed the high level of unpredictability in Argentina for the broad lack of credit. Although the GoA is forcing private pension funds to invest 5% of their capital in the real economy, local financing is otherwise unavailable and international markets are closed. She said even consumer finance was coming to a halt, and what was available is at annual rates of 70-100%. Although the deposit outflow in April-May 2008 showed the fragility of the financial system as a whole, banks remains solvent. As a sector, Martin said they exceed BCRA capital requirements by over 100%, lending to the GoA is much reduced, and the non-performing loan rate is very low. As a whole, it is a competitive sector with tight credit policies and low delinquency rates. Martin closed by commenting that Fitch is the only one of the three major rating companies to maintain a "restrictive default" rating for the GoA, but it will review this status given the news that the GoA plans to pay

its Paris Club debt.

¶17. (U) FRB Governor Randall Kroszner did not clear this
cable.
WAYNE